

200931064

INTERNAL REVENUE SERVICE

TE/GE TECHNICAL ADVICE MEMORANDUM

Area Manager – XXXXXX MAY 5 2009

Taxpayer's Name: XXXXXX  
Taxpayer's Address XXXXXX  
XXXXXX

Taxpayer's Identification Number: XXXXXX

Years Involved: XXXXXX

Conference Held: XXXXXX

Uniform Issue List:  
512.00-00

Legend

T = XXXXXX  
U = XXXXXX  
V = XXXXXX  
W = XXXXXX  
X = XXXXXX  
Y = XXXXXX  
t = XXXXXX  
u = XXXXXX  
v = XXXXXX  
w = XXXXXX  
x = XXXXXX  
y = XXXXXX

Issues

Whether funds derived by T, a state-chartered credit union described in section 501(c)(14) of the Internal Revenue Code, from the following activities should be treated as unrelated business taxable income under section 511 of the Code:

- A. Sale of MEMBERS financial management services (formerly "Plan America")

- B. Sale of credit life and credit disability insurance
- C. Financial management services to U
- D. Financial services to nonmembers through a shared branching network of credit unions
- E. Interest income
- F. Income received from V's provision of services to nonmembers
- G. Sale of checks

### Facts

T is a state-chartered credit union, which is recognized as exempt from federal income tax under section 501(a) of the Code as an organization described in section 501(c)(14)(A).

T's board of directors, supervisory committee and loan committee are comprised entirely of elected members of the credit union who serve on a voluntary basis without compensation.

T's purposes as stated in its Articles of Incorporation are to promote thrift and provide low cost credit for its members.

T's activities include accepting deposits from and maintaining the accounts and savings of its members. These deposit accounts include savings or share accounts on which members earn periodic dividends credited to the accounts and share draft accounts, which are transaction accounts similar to bank checking accounts. T represents that its day-to-day business operations differ from conventional banking institutions in several ways. T states that it conducts its business to reflect its non-profit mutual structure. T makes loans to its members and states that many borrowers have low incomes and might not otherwise qualify for credit from conventional for-profit banks. T also represents that it regularly issues loans for very small amounts, such as loans for auto repairs, which are typically not made by for-profit banks. T indicates that it serves smaller communities than those served by for-profit banks. T also indicates that because of its mutual, non-profit operation, all members, not just those maintaining high minimum balances, are able to earn competitive rates on their deposits and pay low banking fees.

T represents that in order to maintain its financial viability and continue to satisfy its stated purposes of promoting thrift and providing a source of low cost credit, it has endeavored to become a full service financial institution. Consequently, T offers more than just demand deposits and loans. Currently, T provides MEMBERS financial services, financial services to U, and financial services to nonmembers through a shared branching network of credit unions. T also makes credit life and credit disability insurance available to its members in connection with several loan programs. The different types of insurance are

described in more detail below. T also sells checks to its members.

All of these products are underwritten or otherwise provided by third-party insurance companies or other third-party vendors. In each case, T makes its members aware of the purpose and availability of these products, answers members' questions about the products or refers the member to the vendor for additional information, and, with respect to some of the products, obtains and submits applications for coverage, premium payments and claims.

During the years at issue, T made the following types of loans: personal, mortgage, vehicle, and other secured and unsecured loans. The majority of the loans were personal, mortgage and vehicle. No information was provided by T regarding number of loans made during the years at issue and how many of these loans were collateralized.

T did not provide information regarding the default rate on these loans as a percentage of totals for years at issue.

T filed Form 990-T, Unrelated Business Income Tax Return for both years. However, the amounts derived from the sale of the products discussed herein were not included as income derived from unrelated trade or business.

**A. Sale of MEMBERS Financial Services Program (MFS Program)**

The MFS Program is a financial services program that provides services that T does not offer. The MFS Program is W's direct response marketing program. The MFS Program authorizes W to offer insurance products to its members through a local representative. Product offers include mutual funds, variable annuities, fixed annuities, variable universal life, long term care insurance, and term and whole life insurance. W has a representative located at T and T supplies office space, furniture, equipment, phone lines, and marketing support to that representative. Pursuant to the agreement T made with W, W pays a percentage of the new business expense allowance dollars on all products offered by the MFS Program. The percentage varies based on the calendar year-to-date accumulated expense allowance. The amount paid to T is approximately 20 to 50 percent of the new business expense allowance dollars. The monthly service reimbursement is 50 percent of the renewal allowance dollars.

**B. Sale of credit life and credit disability Insurance**

T offers its member/borrowers the opportunity to purchase credit life and credit disability insurance on certain loans. T is a party to, and beneficiary of, standard group credit disability policies with a third party insurance company. Under these policies, a member-borrower who obtains a loan (mortgages and other loans secured by real estate are often excluded) may, if he or she chooses,

obtain credit disability insurance which pays the loan installments during the period of physical disability which impacts the borrower's employment. A loan officer informs each member-borrower of the availability of credit life and credit disability insurance coverage, and if the member-borrower elects to obtain the coverage, the premium charge is added to the borrower's loan balance. Obtaining the credit disability insurance coverage is never a condition of the member's receipt of the loan.

As reflected in the group credit insurance policy and letter agreements, the credit disability coverage is standard coverage which provides that the insurer will repay the balance of a member's loan up to a \$50,000 policy limit. The maximum loan duration covered is 120 months and only credit union members are eligible. T does not offer credit disability insurance in connection with overdraft protection, home equity loans, and real estate loans.

Under the terms of the policy, T is also reimbursed for its administrative expenses in connection with its performance of the prescribed duties as the policyholder. T's employees perform the following duties with respect to the credit disability insurance program:

- During the loan process, and as part of the loan transaction itself, explain the insurance program to member-borrowers;
- Process insurance applications;
- Collect and forward the premiums to the insurance company;
- Receive and forward claims (claims can be filed directly by the member-borrower) to the insurance company; and
- Answer member-borrowers' questions.

T's staff may recommend that the member opt to obtain coverage in situations where coverage appears beneficial based on the level of personal and family resources available for loan repayment in the event of disability.

The credit disability insurance coverage requires monthly premium payments. The charges are calculated by T and added to the member's loan balance. T remits the premiums it has collected, less its expenses as noted above, to the insurance company.

T's commission for its role in coverage issuance and policy administration is 26 to 40 percent of the premiums written for credit disability insurance. This percentage is based on an agreement between T and the insurance company at the time the insurance was purchased.

C. Financial Management Services to U

T wholly owns X, a credit union service organization. X entered into a contract with U for X to provide broad based management of the operations of a smaller, newly created state chartered credit union U. U is chartered by the same state as T. The contract provides, in part, as follows:

- X to manage the operational systems of U and to assist U in establishing appropriate policies and procedures. X agrees to use T's employees and X's employees to provide services to U in opening accounts for members, accepting deposits to accounts, processing withdrawals from accounts, clearing checks drawn upon the checking accounts, accepting loan applications, releasing of loan proceeds to the borrower, preparing necessary reports, and other activity regarding the operation of a financial institution.
- T must permit X to use its facilities in carrying out the business of U.
- X is to provide U policies, procedures and forms for the operation of U. U has final approval regarding such policies, procedures and forms. X has authority to carry out all policies and procedures except for investment activities. U shall direct investment activity.
- X is to hire, supervise and train all such personnel as needed for the services to be provided pursuant to the agreement.
- U shall buy the data processing equipment necessary for handling services provided under the Agreement, including computer software, hardware, operating system licenses and all necessary items for U's data processing operations.
- U's funds shall be processed through X's computer operations center.
- U shall pay X compensation and all costs of X regarding the performance of the Agreement.
- X, in addition to reimbursement for expenses, shall be paid \$t for the first year, and \$u for the second year of the Agreement. After the first two years, the method of determining compensation shall be renegotiated. Compensation from X to T shall be by separate agreement.

Throughout the Agreement, X has agreed to provide the services through the use of T's employees and facilities. T is not a party to the Agreement

between X and U. T has represented that the compensation arrangement it has with X is verbal and that it was unable to detail the terms of the verbal agreement. T also stated that it performed all the services required under the contract on behalf of X to U. For years under audit T recorded \$v in management fees from U.

The details were not furnished because T states that the relationships among T, U and X were never carefully delineated. Additionally, the relationships did not follow the pattern apparently contemplated by the written contract.

U acted as a full service branch of T in a suburb where T had no other branches. The sign on the building showed the names of both credit unions. T states that the revenues generated under the management contract were used to cover T's staffing and administrative support costs for operating the new branch facility. Subsequently, U was merged into T.

X's Form 1120 filed for years under audit show that X's total assets were \$w and the return reflected zero receipts and zero expenditure.

D. Financial management services to nonmembers

During the years at issue, T derived transaction fee income for providing financial services to nonmembers. The financial services provided included, but were not limited to, account withdrawals, deposits, loan payments and check cashing. The services were the same services as provided to its membership. Nonmembers served were members of credit unions that are part of the Service Center Network (SCN).

E. Interest income

During the years at issue, T earned interest income on a loan to V. T owns fifty-five percent of V.

F. Income received from V's provision of services to nonmembers

V provides financial services to members of credit unions participating in a financial services network whereby they may utilize certain Credit Union Service Centers. The Credit Union Service Centers allow members of the various credit unions to transact financial business on a shared branching basis by means of a computer network. V also manages and operates a centralized Indirect Lending Program which provides loan services to members of participating credit unions at various vehicle dealerships. Under the Indirect Lending Program, V generates revenue from fees charged to participating credit unions for each booked loan. T, as well as numerous other credit unions, are served by V.

The Form 1085 – U.S. Partnership Return of Income, Schedule K-1 – Partners Share of Income, Credits, etc. received by T from V for the first year at issue shows approximately \$x in income from trade or business activities. The K-1 received for the second year at issue shows a loss of approximately \$y from trade or business activities.

G. Sale of checks

T has an agreement with Y whereby T agrees to market and/or sell Y's checks to its members. Pursuant to the contract, T agrees to use its best efforts to place orders for all of its members' requirements for checks and check-related products. Y provides the base price of member's checks and T debits member's accounts for the cost of the checks. For the years at issue, T received a commission of approximately 37 percent of the total amount billed.

T provides its membership with brochures and order forms and answers questions regarding X's products.

T informs members that they can order checks directly from other vendors. If a member inquires about purchasing checks from another company, T states that it is an option available to the member. A member can purchase checks directly from other vendors by mail, phone, or over the Internet.

Law

Section 501(a) of the Internal Revenue Code provides, in part, that organizations described in section 501(c) are exempt from federal income tax.

Section 501(c)(14)(A) of the Code specifically exempts from federal income tax credit unions without capital stock organized and operated for mutual purposes and without profit.

Section 1.501(c)(14)-1 of the Income Tax Regulations provides, in part, that credit unions (other than Federal credit unions described in section 501(c)(1) of the Code) without capital stock, organized and operated for mutual purposes and without profit, are exempt from tax under section 501(a).

State-chartered credit unions were first acknowledged as exempt from federal income tax in a 1917 Opinion of the Attorney General. The Attorney General considered credit unions organized under the laws of the Commonwealth of Massachusetts. The Attorney General's opinion described the purposes of credit unions existing at that time:

[I]t is apparent that the purpose of these financial associations is to help people save and to assist those in need of financial help whose credit may

not be established at the larger banks. In reality, they are fundamentally similar and supplemental to the existing agencies for promoting thrift, namely, the savings banks and cooperative banks, except on a much smaller scale.

The Attorney General's opinion also described some of the operations of credit unions--making loans in appropriate amounts to members, "on which a low rate of interest is charged," and that "[p]rompt payment of obligations is a fundamental requirement . . ." The opinion described in detail the procedures by which members' savings were held by the credit union, and how the members earned interest on their deposits. The opinion also pointed to the democratic character of the governance of these early credit unions by their members: "At the annual meeting of the association each member (shareholder and depositor) has but one vote . . ."

After review of the features and operations of these early Massachusetts credit unions, the Attorney General's opinion held that state-chartered credit unions would be exempt from federal income tax. See 31 U.S. Op. Atty. Gen. 178 (1917).

The legal analysis of the Attorney General's 1917 opinion was adopted in Treasury regulations issued in 1918 and this remained the official basis for the tax exempt status of state-chartered credit unions until the Revenue Act of 1951 granted express statutory tax-exempt status to state-chartered credit unions. However, the Revenue Act of 1951 removed tax exemption from savings and loan associations, cooperative banks, and mutual savings banks. The legislative history of the act suggests that the reason these entities lost their exemption was because of their increased similarity to commercial banks and the resulting loss of their original characteristic of mutuality. Specifically referring to the early days of these institutions, the legislative history states:

"The fact that the members were both the borrowers and the lenders was the essence of the "mutuality" of these organizations." See generally S. Rep. No. 781 (Sept. 18, 1951), *reprinted in* U.S. CODE CONG. & AD. SVC. 1969, 1981-97.

Present-day section 501(c)(14)(A) -- as enacted in 1951 -- incorporates the requirements of mutuality and non-profit operation which formed the basis for the Attorney General's recognition of credit unions' tax-exempt status in 1917. Accordingly, the basic purposes of the credit union tax exemption remain essentially the same today as they were in 1917. Based on the Attorney General's opinion, the basis for exemption is the provision of savings accounts and loans to members who may not be served by banks in a non-profit and mutual manner.

Section 511 of the Code imposes a tax on the unrelated business taxable



income of organizations otherwise exempt from federal income tax under section 501(c).

Section 512(a)(1) of the Code provides that the term "unrelated business taxable income" means, with certain modifications, the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less allowable deductions.

Section 512(c) of the Code provides that if a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to such organization, then such organization must include its share of the income from that trade or business in its calculation of UBIT.

Section 513(a) of the Code defines the term "unrelated trade or business" in the case of any organization subject to tax imposed by section 511, as any trade or business the conduct of which is not substantially related (aside from the need of such organization for the income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its exempt function.

Section 1.513-1(a) of the regulations provides that gross income of an exempt organization subject to the tax imposed by section 511 of the Code is, with certain exceptions, includable in the computation of unrelated business taxable income if (1) it is income from trade or business, (2) such trade or business is regularly carried on by the organization, and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

Section 1.513-1(b) of the regulations provides that the term "trade or business" has the same meaning it has in section 162 of the Code, and generally includes any activity carried on for the production of income from the sale of goods or the performance of services.

Section 1.513-1(c)(1) of the regulations states that in determining whether a trade or business is "regularly carried on" within the meaning of section 512 of the Code, regard must be had to the frequency and continuity with which the activities are conducted and the manner in which they are pursued. Hence, for example, specific business activities will ordinarily be deemed "regularly carried on" if they manifest a frequency and continuity and are pursued in a manner generally similar to comparable commercial activities of nonexempt organizations.

Section 1.513-1(d)(1) of the regulations provides that gross income is derived from "unrelated trade or business" within the meaning of section 513(a) of the Code, if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the

purposes for which exemption is granted. The presence of this requirement necessitates an examination of the relationship between the business activities that generate the particular income in question - the activities, that is, of producing or distributing the goods or performing the services involved - and the accomplishment of the organization's exempt purposes.

Section 1.513-1(d)(2) of the regulations provides that a trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income), and it is "substantially related," for purposes of section 513, only if the causal relationship is a strong one. Thus, for the conduct of a trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those exempt purposes. Whether activities contribute importantly to an organization's exempt purposes depends in each case upon the facts and circumstances involved.

In Louisiana Credit Union League, 693 F.2d 525 (5th Cir. 1982), a business league described in section 501(c)(6) of the Code engaged in several activities including the endorsement of insurance to its members. The court analyzed whether these activities were substantially related to the business league's exempt purpose under section 501(c)(6) of advancing the credit union movement, in order to determine whether income generated from those activities resulted in unrelated business income to the business league. In its analysis, the court stated that the "substantial relationship" determination is necessarily a fact-based inquiry." *Id.* at 535. The court also noted that the regulations under section 513 require a case-by-case identification of the exempt purpose, an analysis of how the activity contributes to that purpose and an examination of the scale on which the activity is conducted. The League promoted the purchase of insurance policies from a particular carrier, providing the carrier with convenient services in the marketing and administration of its programs. The court stated that the League's endorsement of group insurance plans was principally motivated by a desire to raise revenue. The court also discussed at length the distinction between group and individual benefit. The court said the distinction between inherently group benefits and individual benefits is analogous to the aggregate/entity concept familiar in partnership taxation.

Just as a member of a partnership may enjoy benefits in his separate capacities as partner and non-partner, so may a member of the . . . [League] . . . enjoy benefits both as a League member and as an individual credit union. Only those activities that benefit the credit unions in their capacities as League members can be considered substantially related to the League's exempt function. This group benefit standard

also accords with the requirement that a business league seek to improve the conditions of an entire line of business rather than perform discrete services for individuals. See Treas. Reg. Section 1.501(c)(6)-1. When the activities of a business league are directed toward the achievement of the common business interest of its members, the benefits that accrue to its members are inherently group benefits.

Id. at 536. The court continued its analysis by stating that insurance endorsement and administration is not the sort of unique activity that satisfies the substantial relationship test, nor do the benefits of that activity suffice. Id. at 536. Rather than merely advising members of the availability and desirability of insurance coverage to credit unions generally, the league promoted the purchase of policies from a particular carrier. The court affirmed the district court's rationale that the league's insurance activities did little more than generate revenue. Because the league's endorsement was basically a fundraising activity, it was by definition unrelated business activity under section 513(a). Id. at 537. Therefore, the court concluded that the League's insurance activities were not substantially related to its tax-exempt purpose of advancing the credit union movement. Rather, the connection between the furtherance of the credit union movement and the selling of insurance was at best tangential.

In Professional Insurance Agents of Michigan v. Comm'r., 78 T.C. 246 (1982), aff'd 726 F.2d 1097 (6<sup>th</sup> Cir. 1984), the court held that promotional and administrative fees and an experience rating reserve refund received by a business league described in section 501(c)(6) of the Code for promoting group insurance programs for its members constituted unrelated business taxable income under section 512(a)(1). In holding that the business league's activities were not substantially related, the court considered whether the league's insurance activities contributed importantly to the league's exempt purpose of advancing the common business interests of independent insurance agents. The court stated that the burden is on the taxpayer to show that the challenged activities contribute directly and importantly to the improvement of conditions in a particular line of business. The court noted that the petitioner's insurance activities did little more than generate revenue for the association and provided members with a convenient and economical service in the operation of their agencies. As such, they stood in sharp contrast to petitioner's educational and legislative activities, which served the broader purpose of improving the general business environment in which insurance agents operated. Thus, the court found petitioner's activity of promoting insurance was not substantially related to its exempt purpose.

In La Caisse Populaire Ste. Marie (St. Mary's Bank) v. U.S., 563 F.2d 505 (1st Cir. 1977), the Government unsuccessfully challenged the exempt status of an organization chartered as a credit union by the State of New Hampshire under section 501(c)(14)(A) of the Code. The Government maintained that the

organization was not exempt because it offered a wide variety of services typically offered by nonexempt full service banks, and was therefore not organized or operated as a credit union. Among these services were checking accounts, mortgage loans, banking by mail, safe deposit boxes and a night depository. This case focused solely on the taxpayer's exemption under section 501(c)(14) and did not address the provisions of sections 511 through 513.

In Alabama Central Credit Union v. U.S., 646 F. Supp. 1199 (N.D. Ala. 1986), a credit union described in section 501(c)(14) of the Code offered cancer and group life insurance to its individual members. The issue was whether commissions that the credit union received from servicing these particular types of insurance policies constituted unrelated business income under section 512. The court did not reach the issue for jurisdictional reasons; however, it stated in a footnote that the petitioner would have lost on the merits of this issue because the policies benefited the insured without any reference to the member's loans or accounts with the credit union. That court stated in dicta that cancer and group life insurance offered by a credit union to its members would result in unrelated business taxable income for the following reasons:

1. Petitioner earned commissions for servicing cancer and group life insurance policies;
2. These policies were for the express benefit of the insured without any reference to the member's loans or accounts with the credit union;
3. Petitioner derived no benefit from the policies other than commission on the sale of said policies earned from the insurance companies which issued the policies;
4. The sale of the cancer and group life insurance policies at issue had no substantial, causal relationship to petitioner's exempt purposes; and
5. The sale of the policies bore no relationship to petitioner's function as a credit union.

Id. at 1208, n. 14.

Rev. Rul. 69-282, 1969-1 C.B. 155, provides that an organization must be formed and operated under the state law governing the formation of credit unions to qualify for exemption under section 501(c)(14) of the Code as a state-chartered credit union.

Rev. Rul. 72-37, 1972-1 C.B. 152, provides that to qualify as a credit union exempt from income tax under section 501(c)(14)(A) of the Code an organization must, in addition to being formed and operated under a state credit union law, operate without profit and for the mutual benefit of its members. The revenue ruling clarified Rev. Rul. 69-282, stating that a state charter is a threshold

requirement for exemption, but not the sole requirement.

Rev. Rul. 60-228, 1960-1 C.B. 200, interprets the substantially related requirement of section 513. An organization exempt from federal income tax as an agricultural organization described in section 501(c)(5) of the Code promotes wider insurance coverage, including life, casualty, and fire insurance, among its members and other local farmers. The insurance programs are provided by several insurance companies, but the organization's administrative and secretarial staff is assigned to the work. The organization receives an overall fee from the insurance company for office and other services rendered them in connection with the insurance programs. The revenue ruling provides that a trade or business is substantially related to an organization's exempt activities if the principal purpose of the trade or business furthers these exempt purposes. However, in this case, such activities are not usually associated with the functions of an agricultural organization and normally would not be carried on by such an organization in furtherance of its exempt purposes. Therefore, these activities are not substantially related to the organization's exempt purposes. Thus, the income resulting from these activities is subject to tax under section 511.

#### Analysis

In determining whether an income-producing activity is an unrelated trade or business, it is necessary to show that (1) there is a trade or business, (2) the trade or business is regularly carried on, and (3) the conduct of the trade or business is not substantially related to the organization's exempt purpose or function. See section 1.513-1(a) of the regulations.

T has agreed that the activities at issue are regularly carried on trades or businesses. Therefore, the sole issue is whether each activity is substantially related to the organization's achievement of its exempt purposes.

Gross income is derived from an unrelated trade or business if the conduct of the trade or business is not substantially related (other than through production of funds) to the purposes for which exemption is granted. Section 1.513-1(d)(1) of the regulations. Determination of the substantial relationship issue requires an examination of the relationship between the business activities which generate the particular income in question and the accomplishment of the organization's exempt purposes. Id. The regulations further state that for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of services from which the gross income is derived must contribute importantly to the accomplishment of those purposes. Section 1.513-1(d)(2) of the regulations. See also Prof'l Ins. Agents of Michigan, supra, (insurance activity was not substantially related because activity did little more than generate revenue and provide members with a service

and did not further taxpayer's exempt purpose of improving business conditions); Louisiana Credit Union League, supra, (League's endorsement of group insurance plans was principally motivated by a desire to raise revenue and, at best, was only tangentially related to the furtherance of the League's exempt purpose of improving business conditions of one or more lines of business. The court found the requisite substantial relationship lacking.)

For T's activities to escape taxation as unrelated business income, the activities must contribute directly and importantly to the accomplishment of one or more of T's exempt purposes—promotion of thrift and providing low cost credit for its members through mutual and nonprofit operation. Section 1.513-1(d)(2) of the regulations. See also Prof'l Ins. Agents of Michigan, supra. We address each of the activities below.

#### MFS Program

T argues that because W's direct response marketing program, the MFS Program, furthers the mutual operations required of credit unions, the income resulting therefrom is not subject to UBIT. T argues that the provision of MFS Program products contributes importantly to the credit union's exempt purpose of promoting thrift and providing basic financial protection to members on a mutual basis. T also argues that the products enhance the core repayment principal of the credit union movement.

The facts do not show how sales pursuant to the MFS Program contribute directly and importantly to T's exempt purpose. T does not state how the sale of products pursuant to the MFS Program provides a mutual benefit to T's members. T has not shown that the sale of products pursuant to the MFS Program encourage savings by members who purchase those products. The MFS Program does not provide any incentive or support for saving, nor does it aid a member in seeking and obtaining a loan. There are no facts showing that the sale of products pursuant to the MFS Program has reduced the cost of providing credit to all members or benefited the membership as a whole in any way. A member's purchase of a product pursuant to the MFS Program provides financial protection to an individual. That purchase, and the resultant protection, does not benefit members as a whole except through the production of income.

Elements of the agreement by T and W are also indicative of the motivating goals of T. For instance, W obtained a covenant not to compete clause which ensured that no other company would offer the same type of products to T's members. If T was truly concerned with enhancing the core repayment principal of the credit union, it would offer insurance from all companies to its members so that its members would have the largest selection of benefits and costs.

Applying the factors of Alabama Central Credit Union, supra, T (1) earns commissions for offering the MFS Program; (2) sells policies for the express

benefit of the insured without any reference to the member's loans or accounts with the credit union; (3) derives no benefit from the policies other than commission on the sale of the policies earned from the insurance companies that issued the policies; (4) the sale of the insurance policies referred to has no substantial, causal relationship to T's exempt purposes; and (5) the sale of the policies bears no relationship to T's function as a credit union.

T did not provide information regarding number of products sold pursuant to the MFS Program for either or

Based on all of the facts and circumstances, T's activities with respect to the sale of products pursuant to the MFS Program do not contribute importantly to accomplishing T's exempt purposes. The facts do not show how the sale of such products contributes to T's exempt purposes of promoting thrift and providing low cost credit. The sale of products pursuant to the MFS Program does little more than produce income for T. Therefore, the sale of products pursuant to the MFS Program is not substantially related to T's exempt purposes and amounts received therefrom are subject to UBIT.

#### Credit life and credit disability insurance

T argues that the sale of credit life and credit disability insurance is directly related to the credit union's specific exempt purposes of fostering thrift among the members (including both the extension of credit to members on reasonable terms, and encouraging savings among the members) and providing services to members on a mutual basis. T further maintains that credit insurance, which is an integral part of a member loan transaction, is a mechanism for assuring the prompt repayment of debts in situations where the financial resources of the borrower, and the borrower's family, become strained as a result of disability.

The facts do not show how sales of credit life and credit disability insurance contribute directly and importantly to accomplishing T's exempt purposes. Credit life and credit disability insurance are not required for the approval of a loan. In fact, credit life and credit disability insurance are not available to members on certain types of loans, such as mortgage and other real estate loans. The member decides whether to purchase credit life and/or disability insurance based on his or her own assessment of whether the insurance will provide a benefit to that individual member. The individual member benefits in that the member need not worry about paying a loan to T in the event of disability. While there is also a benefit to the credit union as the beneficiary, the facts do not show how the sale of credit life and credit disability insurance otherwise contributes importantly and directly to accomplishing T's exempt purposes, other than through the production of income. Availability of credit disability insurance does not encourage savings or assist T in offering low cost credit.

T does not take into consideration the need for this insurance by members. T performs no studies to determine which members may need credit disability insurance, and there is no required corresponding counseling to members who may have more need than others. Although T's staff may recommend insurance based on the level of personal and family resources, these recommendations are not mandatory in specific cases and coverage is not required in these cases.

Additionally, T's arguments do not address the fact that bonuses are paid to employees based on the number of policies sold, providing a profit-motive incentive to T's employees rather than a membership benefit as a whole. In addition, T's commissions are high, ranging from 26 to 40 percent of premiums paid.

Applying the factors of Alabama Central Credit Union, supra, T (1) earns commissions for providing credit life and credit disability insurance; (2) sells policies for the express benefit of the insured albeit with reference to a member's loan with the credit union; (3) derives some benefit from the credit life and credit disability insurance but the primary benefit is production of income, both through the commission on the sale of the insurance earned and the bonuses paid to T employees; (4) the insurance referred to has no substantial, causal relationship to T's exempt purposes; and (5) the insurance bears no relationship to T's function as a credit union.

Looking at the facts with respect to credit life and credit disability insurance, the sale of credit insurance is not substantially related to T's exempt purposes. The available information indicates that the sale of insurance is primarily (1) for the purpose of generating income to T and some of its employees, and (2) for the benefit of the insured rather than for the benefit of T's membership. Based on all of the facts and circumstances, T's activities with respect to the sale of credit life and credit disability insurance do not contribute importantly to accomplishing T's exempt purposes. Therefore, the sale of credit life and credit disability insurance is not substantially related to T's exempt purposes and amounts received therefrom are subject to UBIT.

#### Financial management services to U

T argues that its services further the mutual operations required of credit unions, therefore the income resulting therefrom is not subject to UBIT. T argues that the provision of services and products contributes importantly to the credit union's exempt purpose of promoting thrift and providing basic financial protection to members on a mutual basis.

The facts show that a contract between X and U existed under which X would provide financial management services to U. Another agreement existed between X and T whereby T would assist X in the provision of those services to U. The reality of the relationship between T, X, and U was that T provided



services to U, U compensated T for those services, and X was disregarded. In fact, U has now been merged into T.

The facts do not show how the income received by T pursuant to the agreement between U and X contributes directly and importantly to T's exempt purpose. U is not one of T's members. U's members benefited by T's management of U. While there was also a benefit to some individual members of T by allowing them to use U's facilities to transact business with T, the facts do not show how the management of U contributes importantly and directly to accomplishing T's exempt purposes, other than through the production of income. There are no facts showing that the provision of financial management services pursuant to the Agreement has reduced the cost of providing credit to all members or benefited the membership as a whole in any way.

Applying the factors of Alabama Central Credit Union, *supra*, T (1) earns compensation for financial management of U offered pursuant to the Agreement between U and X; (2) provides financial management services for the express benefit of U without any reference to T's members; (3) derives no benefit from the provision of financial management services to U other than compensation; (4) the sale of the services referred to has no substantial, causal relationship to T's exempt purposes; and (5) the sale of the services bears no relationship to T's function as a credit union.

Based on all of the facts and circumstances, T's activities with respect to the provision of services pursuant to the Agreement between U and X do not contribute importantly to accomplishing T's exempt purposes. The available information indicates that the fees generated from T's financial management of U are primarily for the purpose of generating income to T and for the benefit of the U's membership rather than for the benefit of T's membership. Therefore, the provision of services pursuant to the Agreement between U and X is not substantially related to T's exempt purposes and amounts received therefrom are subject to UBIT.

#### Financial services to nonmembers

T argues that transaction fee income received from nonmembers is irrelevant so long as the underlying trade or business activity itself is substantially related to T's tax-exempt purpose. T argues that its provision of services and products in a reciprocal financial service network is substantially related to its exempt purpose, so all revenue derived from that activity is exempt from UBIT.

The facts do not show how the fees charged to nonmember users of the reciprocal financial service network contribute directly and importantly to T's exempt purpose. The nonmember benefits in that he or she can obtain financial services from T. While there is also a benefit to T's members in that they can obtain services from other credit unions participating in the network, the facts do not show how the transaction fees charged to nonmembers contribute

importantly and directly to accomplishing T's exempt purposes, other than through the production of income. Availability of other credit union branches does not encourage savings or assist T in offering low cost credit.

Applying the factors of Alabama Central Credit Union, supra, (1) T earns revenue for providing nonmembers access to its facilities; (2) T derives little benefit from nonmember use at its branches; (3) charging fees for nonmember use at T's branches has no substantial, causal relationship to T's exempt purposes; (4) the nonmember branch usage referred to has no substantial, causal relationship to T's exempt purposes; and (5) the nonmember branch usage bears no relationship to T's function as a credit union.

Looking at the facts with respect to nonmember transaction fees, such fees are not substantially related to T's exempt purposes. The available information indicates that the fees generated from nonmember usage are primarily for the purpose of generating income to T and for the benefit of the nonmember user rather than for the benefit of T's membership. Based on all of the facts and circumstances, T's activities with respect to the nonmember transaction fees do not contribute importantly to accomplishing T's exempt purposes. Therefore, the nonmember transaction fees are not substantially related to T's exempt purposes and amounts received therefrom are subject to UBIT.

#### Interest income

T argues that its services further the mutual operations required of credit unions, therefore the income resulting therefrom is not subject to UBIT. T argues that the provision of services and products contributes importantly to the credit union's exempt purpose of promoting thrift and providing basic financial protection to members on a mutual basis.

The facts do not show how the income received by T from the loan to V contributes directly and importantly to T's exempt purpose. T does not state how the loan to V provides a mutual benefit to T's members. T has not shown that the loan to V and the interest received therefrom encourage savings by T's members. The loan does not provide any incentive or support for saving for T's member nor does it aid a member in seeking and obtaining a loan.

T received interest income from a controlled entity, V, within the meaning of section 513(b)(13) of the Code. The interest income derived by T is subject to UBIT.

#### Income received from V's provision of services to nonmembers

T argues that income received from nonmembers is irrelevant so long as the underlying trade or business activity itself is substantially related to T's tax-exempt purpose. T argues that V's provision of services and products in a

financial service network and indirect lending program is substantially related to its exempt purpose, so all revenue derived from that activity is exempt from UBIT.

The facts do not show how the fees charged to nonmember users of the financial service network and indirect lending program contribute directly and importantly to T's exempt purpose. The nonmember benefits in that he or she can obtain financial services from V. While there is also a benefit to T's members in that they can also obtain services from V, the facts do not show how the fees charged to nonmembers contribute importantly and directly to accomplishing T's exempt purposes, other than through the production of income.

Applying the factors of Alabama Central Credit Union, *supra*, (1) T earns revenue through V's provision of nonmember access to its service centers and loan program; (2) T derives little benefit from nonmember use at V's service centers and various auto dealerships; (3) charging fees for nonmember use of V's service centers and loan program has no substantial, causal relationship to T's exempt purposes; (4) the nonmember usage referred to itself has no substantial, causal relationship to T's exempt purposes; and (5) the nonmember usage bears no relationship to T's function as a credit union.

Looking at the facts with respect to income derived by nonmember usage of V's services and products, such income is not substantially related to T's exempt purposes. The available information indicates that the fees generated from nonmember usage are primarily for the purpose of generating income to V, which in turn generates income to T, and for the benefit of the nonmember users rather than for the benefit of T's membership. Based on all of the facts and circumstances, V's activities with respect to the nonmember income do not contribute importantly to accomplishing T's exempt purposes. Therefore, the V's income derived from nonmember usage is not substantially related to T's exempt purposes and, under section 512(c) of the Code, amounts received by T therefrom are subject to UBIT.

#### Check sales

Because the sale of checks furthers T's exempt purposes, the income resulting therefrom is not subject to UBIT. Checks allow members access to their funds held on deposit. Accepting member funds for deposit, including allowing the members access to those funds, is obviously a critical and central exempt function of a credit union. Therefore, the sale of checks to T member-borrowers is substantially related to T's exempt purposes.

#### Conclusion

For reasons set forth above, we conclude that the income received by a section 501(c)(14) credit union from the activities listed below are not substantially related to the furtherance of T's exempt purposes and therefore are

subject to UBIT.

- A. Sale of MEMBERS financial management services
- B. Sale of credit life and credit disability insurance
- C. Financial management services to U
- D. Financial services to nonmembers
- E. Interest income
- F. Income received from V's provision of services to nonmembers

We also conclude the sale of checks by T to its members is substantially related to the furtherance of T's exempt purposes and therefore is not subject to UBIT.

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

- END -